REVITALIZING FEDERAL-PROVINCIAL/TERRITORIAL FISCAL RELATIONS

Summary and Recommendations

A Presentation to Western Premiers
by the Finance Ministers of
Alberta, Saskatchewan, Manitoba,
Yukon, Northwest Territories and Nunavut[1]

May 2001

[1] The change of government in British Columbia pursuant to the provincial election of May 16, 2001 has meant that it has not been possible for this Report to be affirmed by British Columbia's Minister of Finance.

2001 Western Premiers' Conference

SUMMARY AND RECOMMENDATIONS

The 2001 Western Finance Ministers' Report focuses on the importance of revitalizing federal-provincial/territorial fiscal relations to meet the fiscal and economic challenges facing Western Canada.

Intergovernmental fiscal relations must be improved to achieve fiscal arrangements that benefit Canadians. Western Finance Ministers are concerned with the lack of an effective forum in which to discuss issues of mutual concern, and with unilateral actions by the federal government that affect areas of provincial/territorial jurisdiction. This weakened state of intergovernmental fiscal relations compromises the ability of federal and provincial/territorial governments to work co-operatively on key taxation, economic and social policy issues.

In particular, Western Finance Ministers are concerned that the federal government:

- is unwilling to fully address the adequacy of the federal contribution to Canada's social programs;
- has weakened the ability of the Equalization Program to meet its constitutional objectives; and,
- is unable to address the current impasse in negotiating new tax collection agreements, which could, if unresolved, result in the breakdown of agreements that have simplified tax collection and enforcement since their inception in 1962.

Western Finance Ministers are seeking the endorsement of the Western Premiers to pursue the following issues with their colleagues in their work leading up to the next Annual Premiers' Conference.

Revitalizing Federal-Provincial/Territorial Fiscal Relations

Western Finance Ministers are concerned with the current state of intergovernmental fiscal relations in Canada. Unilateral actions by the federal government undermine relations between the two orders of government and have significant consequences for provincial and territorial governments – and the people they serve.

Western Finance Ministers call upon the federal Minister of Finance to renew fiscal relations with the provinces and territories by committing to regular meetings of Finance Ministers and senior officials to permit an effective exchange of views and create the potential for compromise between the two orders of government for the benefit of all Canadians.

Ministers further recommend that the federal and provincial/territorial governments accept joint responsibility for such meetings in recognition of the equal and complementary role the two orders of government have in determining the future of fiscal arrangements.

Addressing the Vertical Fiscal Imbalance

The vertical fiscal imbalance – that is, the gap between the distribution of revenue sources and spending responsibilities of the federal and provincial/territorial governments, is large and growing. Spending pressures facing provincial and territorial governments in key provincial/territorial areas of responsibility, particularly health care, will continue to escalate into the future. Governments must work to address this fiscal imbalance in order to maintain the strong social programs that benefit all Canadians.

Western Finance Ministers call upon the federal government to address the growing financial costs associated with Canada's social programs. Ministers further call for the federal government to enter into meaningful discussions with the provinces and territories on this issue, including an appropriate escalator and broader transfers reforms. The federal government should also refrain from introducing cost-shared programs that result in financial costs to the provinces/territories without prior consultation and concurrence.

Addressing the Horizontal Fiscal Imbalance

Fiscal disparities among Canadian provinces and territories are also growing. The federal government has a constitutional responsibility to ensure that each province and territory can provide reasonably comparable services at reasonably comparable levels of taxation.

Western Finance Ministers call upon the federal government to renew its commitment to a strong and adequate Equalization Program. Ministers call for the immediate removal of the ceiling on entitlements.

In addition, Western Finance Ministers note that the federal government has failed to provide appropriate funding, or has unfairly allocated resources among provinces and territories, with respect to Aboriginal affairs and natural resources.

Western Finance Ministers call upon the federal government to:

- recognize the importance of the participation of Aboriginal people in the Western economy and fulfill its financial responsibilities for Aboriginal people in northern, rural and urban areas; and,
- conclude agreements with the Yukon, Northwest Territories and Nunavut regarding the devolution of jurisdiction over land, water and natural resources.

Co-ordinating Tax Policy and Administration

The lack of co-ordination between the two orders of government in undertaking tax policies and tax administration is detrimental to Canadians. The current impasse in renewing the tax collection agreements, and last year's corporate income tax rate reduction that excluded the resource sector, are just two examples that reinforce provincial/territorial concerns with the present state of fiscal relations.

Western Finance Ministers call upon the federal Minister of Finance to negotiate durable and balanced tax collection agreements with the provinces and territories that respect the joint custody of the income tax field as stipulated in the Constitution.

Western Finance Ministers also support a similar approach to other tax policy issues, such as tax competitiveness and other issues affecting the common tax base.

Western Finance Ministers continue to call on the federal government to extend its corporate income tax rate reduction to all business sectors, including the non-renewable resource producing sector.

Addressing Other Priorities of Western Canadians

Intergovernmental co-operation in areas affecting economic development, such as adequate funding for infrastructure and agriculture, is critical to building a Canadian economy that benefits all Canadians.

Western Finance Ministers call upon the federal government to recognize its role and responsibility in responding to immediate and long-term challenges in areas such as agriculture and infrastructure.

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2001 Western Premiers' Conference

REVITALIZING FEDERAL-PROVINCIAL/TERRITORIAL FISCAL RELATIONS

INTRODUCTION

Over the past century, Western Canadians have used hard work, an entrepreneurial spirit and abundant natural resources to create Canada's most dynamic region. All four provinces and the territories have experienced a wide range of economic and fiscal realities in the past. These experiences have reinforced our strongly held values of sharing and helping others to address challenges and achieve their potential. These traits are reflected in our position regarding Canada's fiscal arrangements.

Western Finance Ministers believe that all federal, provincial and territorial Finance Ministers must work together to renew and improve fiscal arrangements, reduce fiscal imbalances, promote strong and balanced economic growth across Canada and ensure that public services are sustained for all Canadians.

CURRENT STATE OF AFFAIRS

Importance of Fiscal Arrangements

In a federation such as Canada, it is imperative that the two orders of government are able to effectively address matters of common interest and joint responsibility. Federal-provincial/territorial fiscal arrangements are such an area where both orders of government have an important role in determining the future of fiscal arrangements.

Fiscal arrangements play an essential role in supporting programs that are of the highest priority to Canadians – health care, education and social services – and which are the responsibility of the provinces and territories. In addition, areas of joint responsibility, such as taxation, require well-functioning fiscal arrangements to ensure that federal and provincial/territorial policies interact in a manner that enhances Canada's competitiveness. As stated by A.W. Johnson, federal-provincial/territorial fiscal relations are about "achieving an equilibrium in the potential for both orders of government and to contribute to the enrichment of Canada -- in both its national and regional aspects – without diminishing one in favour of the other in the doing of it."[1] Simply put, it is about building a strong nation.

Fiscal Arrangements

Federal-provincial/territorial fiscal arrangements typically relate to one of the following four general topics.

1. The funding of major social programs – these programs are of significant interest to all Canadians and are funded by provincial/territorial own-source revenues and federal transfers, the most important being the Canada Health and Social Transfer.
2. Equalization of the fiscal capacity of provincial governments – its purpose is to address fiscal disparities between provinces in order to assist provincial governments in providing comparable levels of public services at comparable levels of taxation.
3. The sharing of tax fields between the national and provincial/territorial governments – there must be a fair distribution of revenue raising ability between the two orders of government to allow each to meet its expenditure responsibilities.
4. Fiscal and economic co-ordination – federal and provincial/territorial tax and economic policies should be co-ordinated in the best interest of Canadians.

[1] A.W. Johnson, "Federal-provincial fiscal relations: an historical perspective," Ottawa and the Provinces: The Distribution of Power and Money, Volume 2 (Toronto: Ontario Economic Council, 1985) 143.

Erosion of Federal-Provincial/Territorial Fiscal Relations

Federal-provincial/territorial fiscal relations have traditionally relied on regular interaction between Finance Ministers to permit a constructive exchange of each government's views. However, a full federal-provincial/territorial Finance Ministers' meeting has not been held since December 1999, and the federal Finance Minister has been reluctant to host such meetings.

By extension, the lack of a forum at the ministerial level to discuss economic, social, fiscal and tax policy matters has significantly diminished the effectiveness of intergovernmental relations at the Finance officials' level. This is evident with the Continuing Committee of Officials, which is the Finance Deputy Ministers' committee that co-ordinates relations between officials, in that it has not met since January 1999.

This is in stark contrast to the frequency of meetings held for other major policy sectors. Federal-provincial/territorial Ministers and Deputy Ministers responsible for each of the other major policy sectors normally meet at least once per year, and more if specific issues arise. In addition, as these meetings may lead to initiatives that have expenditure implications, it is appropriate for Finance Ministers to meet to discuss the financial implications for both orders of government.

Despite the federal Finance Minister's reluctance to participate in federal-provincial/territorial meetings, provincial/territorial Finance Ministers continue to meet on a regular basis. In addition, Western Finance Ministers believe that outstanding issues such as the adequacy of funding for priority social programs, taxation policy and administration, and the fiscal imbalance that exists between the two orders of government necessitate regular high-level discussions to achieve long-term sustainability in our fiscal arrangements.

Indicators of a Deteriorating Relationship

The following examples illustrate the deterioration in fiscal relations.

- Absence of an effective process – There is a lack of a strong and effective process to discuss fiscal matters. For example, federal-provincial/territorial Finance Ministers have not met since December 1999, and the federal Finance Minister has been reluctant to host such meetings.
- Funding for social programs – With the introduction of the CHST, the federal government reduced funding for social programs by $6.2 billion annually, from $18.7 billion in 1994-95 to $12.5 billion in 1997-98. While the September 2000 federal announcement was a good first step in restoring these cuts, the federal government's share of social program funding is still far below its 1994-95 level.
- Equalization ceiling – Although directed by the Prime Minister in September 2000 to consult with the provinces, the federal Minister of Finance had minimal discussions on the level of the Equalization Program's ceiling beyond 1999-2000.
- Taxation of the resource sector – In its 2000 Budget, the federal government specifically excluded the resource sector from its CIT rate reduction. Provinces were not consulted on the exclusion of this activity, which is an important segment of the Western economy.
- Tax Collection Agreements (TCAs) – The impasse that exists between some provinces and the federal government regarding the level of provincial income tax flexibility for purposes of renewing the TCAs could risk the future of these Agreements.
- Funding for Aboriginal people – Rapidly growing cost pressures for social programs and other initiatives are placing increasing demands on provincial/territorial finances in the absence of adequate federal funding.

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Fiscal arrangements play an essential role in supporting programs that are of the highest priority to Canadians – health care, education and social services – and which are the responsibility of the provinces and territories. In addition, areas of joint responsibility, such as taxation, require well-functioning fiscal arrangements to ensure that federal and provincial/territorial policies interact in a manner that enhances Canada's competitiveness. As stated by A.W. Johnson, federal-provincial/territorial fiscal relations are about "achieving an equilibrium in the potential for both orders of government and to contribute to the enrichment of Canada – in both its national and regional aspects – without diminishing one in favour of the other in the doing of it."[1] Simply put, it is about building a strong nation.

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Despite the federal Finance Minister's reluctance to participate in federal-provincial/territorial meetings, provincial/territorial Finance Ministers continue to meet on a regular basis. In addition, Western Finance Ministers believe that outstanding issues such as the adequacy of funding for priority social programs, taxation policy and administration, and the fiscal imbalance that exists between the two orders of government necessitate regular high-level discussions to achieve long-term sustainability in our fiscal arrangements.

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- Funding for Aboriginal people – Rapidly growing cost pressures for social programs and other initiatives are placing increasing demands on provincial/territorial finances in the absence of adequate federal funding.

An unfortunate consequence of the lack of federal-provincial/territorial Finance Minister and Deputy Minister meetings is the federal government's willingness to make unilateral decisions on issues that are of interest to all jurisdictions. Another by-product has been the escalation in bilateral discussions between the federal government and provincial/territorial jurisdictions on issues that have a national perspective, which Western Finance Ministers believe is inappropriate.

This approach does not ensure a comprehensive and reasoned exchange of views to achieve fair, durable and responsive intergovernmental fiscal arrangements, and thereby threatens the quality of life that Canadians have come to enjoy and expect.

Revitalizing Fiscal Relations

To revitalize federal-provincial/territorial fiscal relations, Western Finance Ministers call for the two orders of government to commit to regular meetings of Finance Ministers and senior officials.

Each Spring, provinces/territories would host a meeting of federal-provincial/territorial Finance Ministers to discuss general issues of national and jurisdictional importance. Issues may include, but are not limited to, co-ordinating tax policy and administration, improving fiscal arrangements that support Canada's social programs and strengthening the economy.

Each Fall, the federal government would host a federal-provincial/territorial Finance Ministers meeting to discuss a broad range of issues, including a strong focus on upcoming federal and provincial/territorial budgets. This meeting would also provide a forum for discussing outstanding fiscal issues.

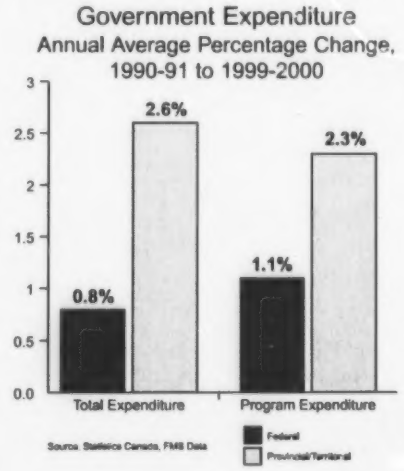
Twice a year, the Continuing Committee of Officials would meet to co-ordinate their activities around the Finance Ministers' meetings. These meetings would also be used to provide direction to sub-committees of Finance officials.

CURRENT PROVINCIAL/TERRITORIAL FISCAL ISSUES

Vertical Fiscal Imbalance

There is a gap in the distribution of revenue sources and spending responsibilities between Canada's two orders of government. Since World War II, this gap has favoured the federal government.

Although federal and provincial/territorial revenues have grown at similar rates over the past decade, an increasing divergence in expenditure pressures is anticipated. This gap creates a vertical fiscal imbalance (VFI), which is expected to widen as demographics and cost pressures increase expenditures in areas of provincial/territorial jurisdiction, such as health care, education, social services and infrastructure.

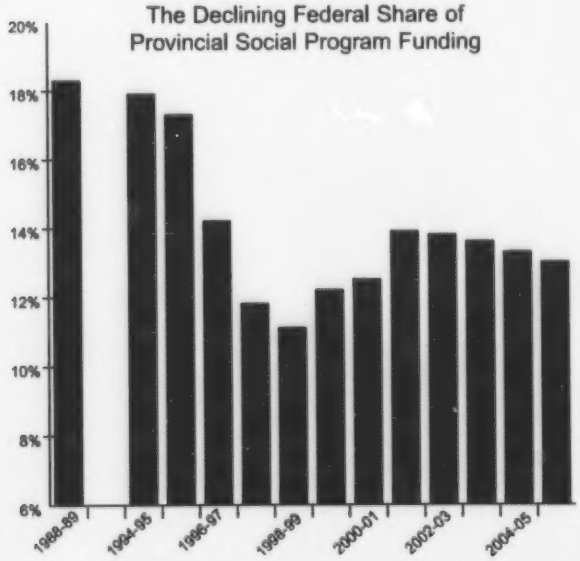


Provinces and territories have shouldered the burden of increasing program costs. At a time when Canadians continue to rank health and education as their first priorities, the federal financial contribution to Canada's social programs through the Canada Health and Social Transfer (CHST) has fallen as a share of provincial/territorial spending in this area from over 18 per cent in 1988-89 to just over 12 per cent in 2000-01.

At the September 2000 First Ministers' Meeting, the federal government agreed to increase CHST cash funding and ensure the equalization ceiling did not apply for 1999-2000, thereafter allowing the entitlements to grow up to the rate of growth of GDP. These initiatives were seen as a positive first step towards restoring balance in federal-provincial/territorial fiscal arrangements.

However, the provinces and territories continue to face major pressures in the areas of health care, education and social services.

Health care is the largest expenditure pressure provinces and territories face, and costs are expected to continue to increase at least at an average rate of 5 per cent per year due to an increasing and aging population, changing technology and a widespread need to address the shortage of health care providers.



Note: provincial program spending includes health care, education and social services. Projections beyond 2001-02 show levels that would occur if no further enhancements follow the September 2000 federal announcement.
Sources: Federal Department of Finance, Public Accounts Spending Data (education and social services); Canadian Institute for Health Information (health care)

A recent C.D. Howe Institute Commentary warned that "demographic changes will put massive pressure on many provinces' health care budgets in the decades ahead." The author recommends that federal-provincial/territorial transfers be reformed to meet this challenge.[1]

Education, including post-secondary, represents another significant and important portion of program spending for the provinces/territories. Expenditures in education are expected to accelerate due to the increased demographic pressures of the baby boom echo in the medium term and, in part, by federal initiatives to encourage participation in post-secondary education. In addition to the fact that education expenditures face upward pressure during an economic slowdown as individuals choose to pursue increased education, the pursuit of life-long learning is increasing public demand for post-secondary education.

Strong social programs and education are critical to providing opportunities for Aboriginal people to participate in the economy. Over the past two decades, the federal government has failed to provide adequate funding for a number of services and programs that it had previously provided to Aboriginal Canadians, particularly to those living off reserve. This federal off-loading of responsibilities has placed an increasing financial burden on provinces and territories, which have been compelled to provide an increasing share of these services, including health and other costly social programs, in the absence of adequate federal funding. Without substantial improvements to the transfers arrangements, these continuing cost pressures threaten the ability of provinces and territories to sustain our most important social programs.

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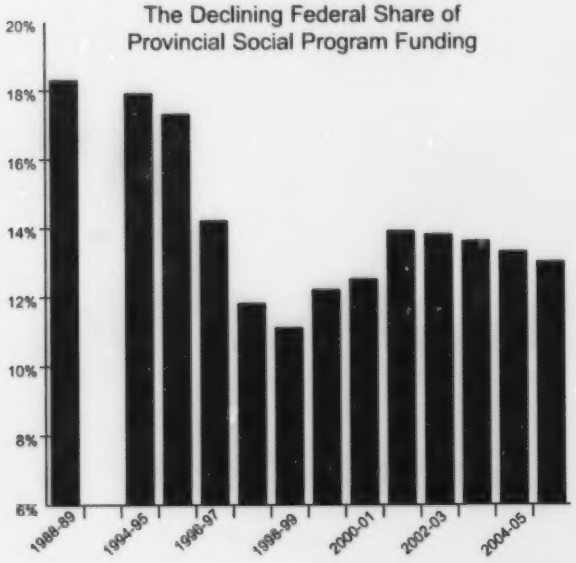
The Declining Federal Share of Provincial Social Program Funding



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Horizontal Fiscal Imbalance

The revenue raising capacity of the provinces/territories is not evenly distributed throughout Canada. While the vertical fiscal imbalances noted in the previous section may be addressed through increased CHST transfers or a reassignment of tax bases, the horizontal imbalances must be addressed differently.

Under Section 36(2) of our Constitution, the federal government is committed to the principle of making equalization payments to ensure that all provinces have sufficient revenues to provide reasonably comparable services at reasonably comparable tax rates. The federal government's decisions to arbitrarily restrict the operation of the Equalization Program impair its ability to address fiscal disparities among provinces. Examples include the introduction of a ceiling on entitlements and the exclusion of certain provincial and local revenue sources.

In the north, formula-based transfers are provided to the territorial governments. However, while the territories have the same spending responsibilities as provinces, the federal government retains the authority for non-renewable resource development and its corresponding revenue. Yukon, Northwest Territories and Nunavut are still seeking federal agreement on a formal process to devolve jurisdiction over their lands, water and natural resources, similar to that secured by the provinces. Such devolution would put the necessary revenues and administrative tools in the hands of the appropriate territorial and First Nations governments to help them take control of their own economic development and diversification.

The consequences of horizontal imbalances, unless ameliorated, will continue to create fiscal disparities. This means that either services will not be provided to the same degree as in the past, or tax rates will need to be higher to compensate for lower fiscal capacity. Both are harmful to balanced economic growth throughout Canada.

Tax Administration

Western Finance Ministers are concerned about the lack of progress toward renewing the Tax Collection Agreements (TCAs). The agreements provide taxpayers with the benefits of a harmonized tax collection system, so that only one tax collector, one set of tax rules and one tax form are necessary.

These agreements are being renegotiated to reflect the changeover of provincial income tax from a tax-on-tax system to a tax-on-income system of calculating income taxes payable. However, as part of this renewal, the federal government is attempting to introduce other changes to the agreements. Of particular note is that provinces and territories are being asked to agree to a fundamental change that restricts the use of the income tax system to implement economic and social policy initiatives.

Western Finance Ministers reject this proposal by the federal government as a contradiction of the principle of joint custody for income taxes as stipulated in the Constitution. Ministers are concerned that by insisting on this change to the existing agreements, the federal government has put at risk a long-standing tax collection arrangement that has been the envy of many other countries.

Revisions to the agreements are matters of negotiation between the two orders of government. The current federal attempt to impose its will on the provinces and territories will not be successful. Western Finance Ministers are concerned that unless this issue is resolved, taxpayers may see an unnecessary duplication of efforts and higher costs associated with administering the tax system.

Funding for Aboriginal People

Western Canada's prosperity depends, in part, on the full participation of all people in the economy. As a result, it is critical that the economic and social conditions of Aboriginal people in Canada are improved to ensure that all are able to participate in and contribute to the economy.

The current demographic, social and economic situation of Aboriginal people indicates rapidly growing cost pressures in the area of health, education and social support. In addition, additional expenditure demands are being created by self-government, treaty and land claims agreements.

The failure of federal Aboriginal policies impact on the health and welfare of Aboriginal people and their communities by restricting their ability to take advantage of employment and business opportunities. Meanwhile, the financial consequences of the federal approach to Aboriginal issues are borne by the provinces and territories. As a result, inadequate federal funding for Aboriginal people will have serious long-term consequences for federal and provincial/territorial governments and economies.

Western Finance Ministers therefore continue to call upon the federal government to accept its fiscal, historical, fiduciary and constitutional responsibilities for Aboriginal people in northern, rural and urban areas and take meaningful action to overcome the issues that have not been adequately addressed to date.

Addressing Other Shared Priorities

Western Finance Ministers attach a very high degree of importance to effective co-ordination of each governments' efforts and the federal funding role in other areas of shared responsibility between the two orders of government.

Examples include:

- Funding for agriculture and infrastructure. A strong agricultural sector and a safe, well-developed transportation system are essential to the economy of Western Canada.
- Addressing tax competition pressures. This issue is not restricted to the federal domain. Given the shared responsibility of certain taxation fields between the federal government and the provinces/territories, it is paramount that the federal government recognize the international tax competitiveness concerns of provinces/territories.

Western Finance Ministers call upon the federal government to engage in a dialogue that would permit a useful exchange of perspectives on these issues of joint concern.

CONCLUSION

Western Finance Ministers are committed to supporting and protecting social programs and strengthening the economy of Western Canada. A revitalized approach to intergovernmental fiscal relations is necessary to:

- assure Canadians that federal, provincial and territorial governments are committed to working together to maintain strong social programs; and,

- provide opportunities to capitalize on the economic potential of the West, thereby enabling the provinces and territories to respond to the realities of an increasingly competitive global economy and continue to be important contributors to Canada's overall economic well-being.

In developing a proposal to address the current situation of deteriorating federal-provincial/territorial fiscal relations, Western Finance Ministers are realistic about what can be achieved. Western Finance Ministers recognize that, with a federation as diverse as Canada, some intergovernmental conflict is inevitable. It is appropriate for the individual provinces/territories to question federal policies that impact areas of provincial responsibility and that can affect each jurisdiction of Canada differently. When conflicts arise, the challenge becomes successfully dealing with those conflicts.

Western Finance Ministers believe that it is important to achieve and maintain a constructive environment for federal-provincial/territorial fiscal relations based on effective and respectful co-operation and discussion. Ongoing co-operation is not only desirable, but also necessary given the common goals and shared responsibilities for fiscal matters.

REVITALIZING FEDERAL-PROVINCIAL/TERRITORIAL FISCAL RELATIONS

Economic Potential of Western Canada

BACKGROUNDER

A Presentation to Western Premiers
by the Finance Ministers of
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ECONOMIC POTENTIAL OF WESTERN CANADA

Introduction

Western Canada is an area of vast potential in many economic sectors. A common perception of Western Canada is that it is rich in natural resources, and that these resources form the entire basis of its economic potential. While it is true that the West has an abundance of natural resources which hold tremendous development potential, including crude oil, natural gas, timber, water and minerals such as gold, diamonds, base metals, potash and uranium, resources are only part of the story of the economies of the Western provinces and territories.

Economic diversification has long been a priority of western Canadian governments and industries, and over time this has led to the development of:

- a strong manufacturing and processing sector;
- sophisticated hydroelectric production and transmission systems;
- a highly-developed and increasingly value-added agricultural sector;
- advances in the knowledge economy, including a strong biotechnology sector; and,
- quality services and a vibrant tourism industry.

Most of Western Canada's natural resource and manufacturing production is exported, mainly to the United States. However, the financial, economic and taxation environment within which companies must operate is uniquely Canadian.

It continues to be in the collective interest of all Canadian jurisdictions to ensure that the major United States export markets for resources, goods and services produced in Western Canada remain open. There has recently been a strong and sustained increase in the price of natural gas due to improved market opportunities in the United States. This has facilitated the rapid development of this industry in producing provinces and territories. Western jurisdictions also export substantial quantities of crude oil and hydro-electricity to the United States.

In each of the Western provinces and territories, the forest industry holds great potential for economic development as long as export markets for softwood and value-added forest products remain open. With the recent expiry of the Canada-United States softwood lumber agreement, the near-term future of this industry is uncertain.

Agriculture is another sector that is extremely important to the economies of the Western provinces. In recent years, this sector has faced increasing financial pressure due to falling grain prices and rising input costs, while federal agricultural income support programs in Canada have been inadequate.

The similarities and differences in the geologic, geographic and demographic makeup of the Western jurisdictions present both opportunities and challenges. Many of these unique traits were noted in an April 2001 study by the Canada West Foundation entitled *State of the West: Western Canadian Demographic and Economic Trends*.

Economic development and diversification in Western Canada depends on many factors such as geography, population, tax structures and infrastructure. It also depends on federal transfer programs to help build and maintain the proper infrastructure for development and diversification, and to help alleviate regional disparities which tend to create and exacerbate interjurisdictional inequities.

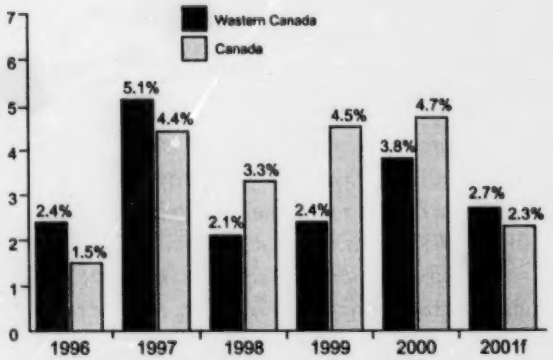
Territorial governments face unique challenges in developing their northern economies. At the same time, however, they depend on the federal government for the majority of their revenues. The devolution of jurisdiction to appropriate territorial and First Nations governments over their lands, water and natural resources would put both the necessary revenues and administrative tools in the hands of the territories to help them undertake control of their own economic development and diversification. This could strengthen the potential fiscal capacity of appropriate territorial and First Nations governments and reduce dependency on the federal government. While the Yukon is completing the devolution process, the Northwest territories and Nunavut are still seeking agreement on a formal process to determine how the transfer of authority over lands, water and natural resources will devolve.

Economic Outlook for Western Canada

Private sector forecasters expect Western Canada to grow by 2.7 percent in 2001, compared to 2.3 percent for Canada as a whole, as slower economic growth in the United States will have a significant impact on the Ontario economy, in particular. However, strong energy prices will keep Western energy exports healthy, but other commodity exports, such as lumber, should weaken. The unemployment rate is projected to remain stable in 2001 at 5.6 percent in the West and increase to 7.2 percent for Canada as a whole.

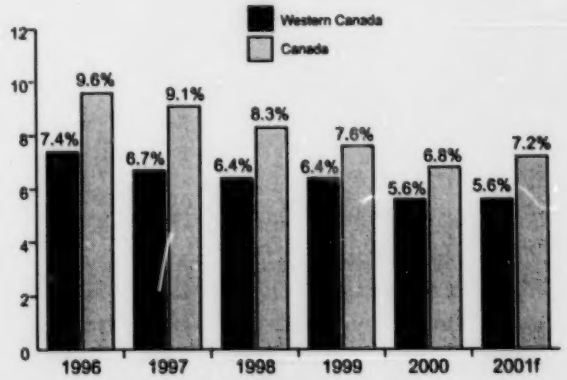
Growth in the West will slow in 2001 as weaker economic activity in the United States and central Canada reduces exports of goods and services. While there are still significant differences among the Western Canadian economies, forecasts still project growth for all provinces in 2001, with Alberta leading the way at 4.2 percent, followed by Manitoba at 2.4 percent, Saskatchewan at 2.3 percent and British Columbia at 2.1 percent.

Real GDP Growth



Source: Conference Board of Canada: Survey of Private Sector Forecasters

Unemployment Rate



Source: Statistics Canada: Survey of Private Sector Forecasters

Conclusion

Western Finance Ministers see an important role for the federal government in working with Western provincial and territorial governments to realize their full economic development potential.

Western Canada has strong north-south economic ties that support economic growth. As such, Western provinces and territories have a keen interest in the resolution of any trade disputes arising between Canada and the United States.

Co-ordination of interjurisdictional tax policies is also important in achieving economic growth. The recent federal decision to introduce a phased reduction in its corporation income tax rate for all companies except non-renewable resource producers is seen as discriminating against the West, where the majority of the affected resource producers are based.

With the changing Aboriginal demographics, ensuring that Aboriginal people have opportunities to fully participate in the continued economic development of Western Canada is a critical issue that must be addressed. A growing proportion of Aboriginal people participating in the mainstream economy would greatly enhance the economic development potential of the Western provinces and territories.

Finally, the federal government can assist economic development in the Western provinces and territories by participating in co-ordinated development programs such as infrastructure funding, and by ensuring that Canada's social programs, including health and education, are adequately funded.

REVITALIZING FEDERAL-PROVINCIAL/TERRITORIAL FISCAL RELATIONS

Vertical Fiscal Imbalance

BACKGROUNDER

A Presentation to Western Premiers
by the Finance Ministers of
Alberta, Saskatchewan, Manitoba,
Yukon, Northwest Territories and Nunavut[1]

May 2001

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2001 Western Premiers' Conference

VERTICAL FISCAL IMBALANCE

Introduction

A gap currently exists in the matching of revenue sources and spending responsibilities between Canada's two orders of government. This gap is referred to as the vertical fiscal imbalance. In the absence of remedies, this imbalance is expected to widen in the future as provincial/territorial expenditure pressures continue to outpace those of the federal government.

While federal and provincial/territorial revenues have grown at roughly similar rates over the past decade, and are expected to grow at similar rates into the future, an increasing divergence in expenditure pressures is anticipated, contributing to a deepening vertical fiscal imbalance between the two orders of government.

Federal Expenditure Pressures

The federal government's main expenditure pressures are debt servicing, Old Age Security, Employment Insurance and transfers to the provinces. Federal program expenditure in the 1990s grew at low rates, primarily due to the fact that expenditure growth in most federal program areas is capped and, in many cases, falling.

Debt servicing costs represent roughly 25 per cent of the federal government's total annual expenditure. This is an expenditure area that is expected to fall in the future. Two factors drive debt servicing costs – the level of the debt and interest rates. The federal government is forecast to run surpluses for the short to medium term that will result in declining debt and a decline in debt servicing costs. Even under scenarios where annual real GDP growth falls below 2 per cent, the federal government is not expected to run deficits. Interest rates are also declining and are forecast to remain low over the medium term. Thus the debt-servicing costs of the federal government are unlikely to increase due to interest rate pressure.

The Federal Position on the Vertical Fiscal Imbalance

In April 2001, the federal Intergovernmental Affairs Minister stated that there is no fiscal imbalance. Further, he indicated that the federal surplus will be limited over the next few years.

While the provinces/territories do not disagree that the federal government will have limited flexibility over the next two or three years, this will not be the situation over the medium term.

This is supported by an independent study commissioned by the provinces/territories (G.C. Ruggeri 2000 – *A Federation Out of Balance*). The study concluded that the difference in revenue and expenditure growth between the federal government and the provinces/territories means that, without other policy changes, the federal surplus in 2019-20 will be $153.7 billion while the combined provincial/territorial surplus will be only $13.9 billion. The Toronto-Dominion Bank came to a similar conclusion for the longer term in a study released March 2001 entitled *Using the Federal Budget Surplus – Is There Any Left?*

The federal government is therefore in a position to address this fiscal imbalance by increasing support for Canada's social programs without jeopardizing its fiscal situation.

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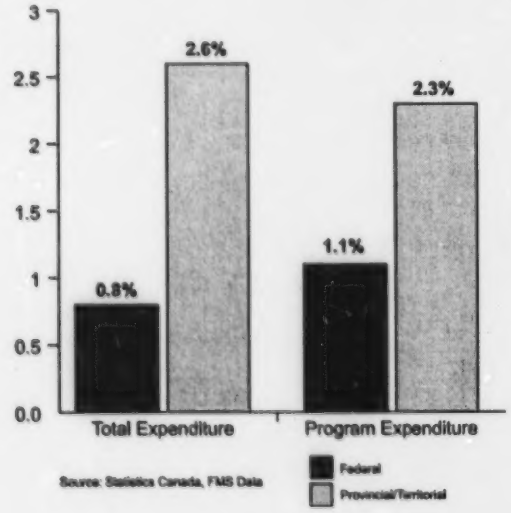
The federal program with the greatest future expenditure pressure is Old Age Security. The average annual growth rate for this program from 1990-91 to 1999-2000 was 3.5 per cent. Old Age Security was $23.4 billion, or 21 per cent of federal program expenditures, in 1999-2000. It is forecast to increase moderately in the medium to long term as a product of an aging Canadian population.

Employment Insurance represents the largest expenditure risk for the federal government whenever the national economy slows. However, with an estimated current $20 billion Employment Insurance accumulated surplus, the question is how much would be required to finance increased benefits in the event of an economic slowdown. In 1999-2000, the federal expenditure for Employment Insurance was $11.3 billion, or 10.1 per cent of program spending, while revenue from the payment of Employment Insurance premiums accounted for $18.5 billion, or 11.2 per cent of total revenue.

Government Expenditure

Annual Average Percentage Change, 1990-91 to 1999-2000



Source: Statistics Canada, FMS Data

Transfers to the provinces in 1999-2000 accounted for $23.2 billion, or 15.1 per cent of federal program spending. Of the recent increases in spending, 31 per cent have been in the form of increased transfers to the provinces. However, during the federal government's period of fiscal restraint, cash transfers to the provinces were cut by 33 per cent, whereas other federal program expenditures were cut by only 8 per cent.

The May 17, 2001 Federal Economic Update displayed some evidence that the federal government's expenditure pressures are currently not increasing despite slower economic growth, as it was able to allocate an additional $5 billion to debt reduction for its fiscal year 2000-01, over and above its original forecasted amount of $10 billion. In addition, it appears that the impact of the economic slowdown has affected the federal government's expenditure pressures for 2001-02 and 2002-03 only very marginally, as it is still forecasting healthy surpluses for these fiscal years, over and above its contingency reserve and economic prudence amounts which have remained fully intact.

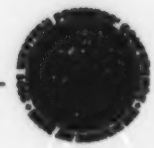
Provincial/Territorial Expenditure Pressures

The provinces and territories face major pressures in the areas of health care, education and social services. Health care is the largest expenditure pressure for provinces, and has increased as a share of program expenditures from 30 per cent in 1990-91 to almost 35 per cent in 1999-2000.

Health care is the largest expenditure pressure provinces and territories face, and costs are expected to continue to increase at least at an average rate of 5 per cent per year due to an increasing and aging population, changing technology and a widespread need to address shortages of health care professionals.

Education, including post-secondary, represents another significant and important portion of program spending for the provinces/territories. Expenditures in education are expected to accelerate due to the increased demographic pressures of the baby boom echo in the medium term and, in part, by federal initiatives to encourage participation in post-secondary education. In addition to the fact that education expenditures face upward pressure during an economic slowdown as individuals choose to pursue increased education, the pursuit of life-long learning is increasing public demand for post-secondary education.

Education and strong social programs are critical to providing opportunities for Aboriginal people to participate in the economy. Over the past two decades, the federal government has failed to provide adequate funding for a number of services and programs that it had previously provided to Aboriginal Canadians, particularly to those living off reserve. This federal off-loading of responsibilities has placed an increasing financial burden on provinces and territories, which have been compelled to provide an increasing share of these services, including health and other costly social programs, in the absence of adequate federal funding.



REVITALIZING FEDERAL-PROVINCIAL/TERRITORIAL FISCAL RELATIONS

Rising Health Costs

BACKGROUNDER

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2001 Western Premiers' Conference

RISING HEALTH COSTS

Introduction

In 2000, a major study produced by provinces and territories, *Understanding Canada's Health Care Costs*, concluded that existing and emerging health care cost pressures had the potential to increase provincial/territorial costs at an annual rate well in excess of five per cent.[1]

Health Care Cost Drivers and Cost Accelerators Facing the Provinces

The following are some of the facts presented in the study.

- The population aged 85 and over will grow by 61 percent over the next decade, compared to 21 per cent for the senior population as a whole (age 65+), doubling the expected increase in long term care beds and increasing pressure on publicly funded drug plans.
- Emerging and new technologies in such areas as cardiac care and joint surgery are likely to accelerate increases in the costs of health services.
- The cost of drugs is growing dramatically – beyond what would be predicted by population growth or aging.
- New or increasingly prevalent diseases may significantly increase costs for all parts of the health system (e.g. HIV/AIDS, hepatitis C, traumatic brain injury).
- Canadian hospitals have under-invested in information systems and will need to catch up.
- The expectations of the Baby Boom generation may significantly alter patterns of use of health services. Their strong sense of entitlement to health services is dramatically different from that of earlier generations.
- Rural and remote service delivery costs per patient are increasing steeply, exacerbated by the difficulty of recruiting and retaining service providers.
- Shortages of trained staff (particularly nurses, physicians, and technologists) will accelerate labour market costs.

Scope of Publicly Funded Health Services

The future costs of the health system will also be dependent upon the outcome of public pressure to increase the range of publicly funded health services. Some of the changes being advocated could add to the costs of the system, such as:

- providing full prescription drug coverage;
- providing a continuum of care for an aging population – including home based support, assisted and supportive housing, long term care, and acute care; and,
- addressing human resource shortages, particularly in nursing, through additional training and retraining, and improvements in the workplace.

Some of the changes being advocated do have the potential to ease health cost pressures to some extent. Prominent among these is a rationalization of the use of services from different health care providers so that a given standard of care can be produced more efficiently.

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[1] The study estimated that the basic drivers of health care costs – not including the special cost accelerators highlighted on this page - would produce a growth rate of costs of just under 5 per cent over the next two and a half decades.

Provinces and territories will need to continue to actively manage the system to address expenditure pressures and meet future demand. It is important to note that provinces and territories cannot manage these cost pressures alone – substantive, permanent and growing federal support is essential to the sustainability of the system.

Provincial/Territorial Collaborative Effort

Provincial and territorial governments, following a September 2000 agreement by First Ministers, are collaborating on many areas of health care reform. Areas of major focus are:

- reforming Primary Health Care to provide access to services outside of expensive emergency departments;
- co-ordinating efforts on the supply of doctors, nurses, and other health care personnel;
- expanding home care and community care programs;
- developing strategies for assessing the cost-effectiveness of prescription drugs;
- investing in health information technologies; and,
- making greater use of performance measures.

The existence of many potential cost pressures means that an assumed annual rate of growth of five per cent in health care expenditures in Canada is highly conservative. The overall cost effect of implementing the more prominent health care reforms is not yet clear. Certain reforms do have the potential to create savings while others will require additional investment.

REVITALIZING FEDERAL-PROVINCIAL/TERRITORIAL FISCAL RELATIONS

Federal-Provincial Tax Collection Agreements

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FEDERAL-PROVINCIAL TAX COLLECTION AGREEMENTS

Introduction

The Federal-Provincial Tax Collection Agreements (TCAs) have provided a basis for the administration of provincial income taxes by the federal government since 1962. With the exception of Quebec, all provinces and territories have entered into such arrangements for the administration of Personal Income Tax. The agreements also cover Corporation Income Tax administration for each of the provinces and territories except Alberta, Quebec and Ontario.

The TCAs provide taxpayers with the benefits of a harmonized tax collection system. They stipulate that the federal government will pay all costs associated with administering the basic provincial/territorial income tax systems and that it is responsible for unpaid provincial/territorial taxes. In exchange, the federal government retains any penalties and interest associated with unpaid provincial/territorial taxes.

The TCAs prescribe the rules and costing arrangements for any measures beyond the basic provincial tax structures that are administered by the federal government. The provinces have also been free in the past to implement tax measures outside the agreements on a self-administered basis. Over the years, various provinces have adopted a number of measures that are outside the scope of the agreements.

Beginning in 2001, all the provinces are levying their personal income taxes by applying provincial income tax rates directly to taxable income (referred to as "tax on income"). The federal government has required that, as part of this arrangement, provinces accept a common definition of taxable income. The three territories have not yet introduced tax on income structures.

Since the move to tax on income is a significant departure from the former method of calculating provincial income taxes, the TCAs are being redrafted to reflect the new arrangements.

Provincial Issues

Definition of the Tax Base

The federal government has proposed a change in the TCAs that would limit a province's ability to implement a tax measure that significantly alters the definition of taxable income for provincial tax purposes (i.e. minor deviations would be permitted under certain conditions). These rules would affect the introduction of provincial tax credits that alter the level of provincial income taxes on selected income.

In the interest of a harmonized tax system, most provinces generally support a common definition of the tax base. However, some provinces object to the strict federal definition of the tax base and believe that the federal government should not be allowed to unilaterally decide what constitutes the tax base for provincial income tax purposes.

Provincial Income Tax Flexibility

The old TCAs limit the requirement for federal approval of provincial measures to those being administered on behalf of the province by the federal government. This has given provincial governments the ability to introduce self-administered policy initiatives outside of their particular tax collection agreements without jeopardizing their agreements with the federal government.

The proposed new TCAs provide the federal government with discretion in determining whether a provincial income tax measure results in the imposition and collection of income taxes in a manner that is contrary to the national tax base. The federal government proposes to extend this discretion to measures introduced outside the agreements, restricting a province's ability to self-administer provincial income tax policies.

Western Finance Ministers consider the federal decision to try to extend its policy influence to provincial tax measures administered outside the TCAs as a significant change to the existing federal-provincial tax relationship. In this regard, Western provinces consider the federal proposal to be a significant encroachment on provincial income tax policy.

Western provinces/territories believe the TCAs represent a long-standing compromise that reflects the joint federal-provincial constitutional authority to levy income taxes while achieving efficient tax administration through national consistency in applying income taxes throughout Canada.

Western Finance Ministers are very concerned that the current impasse between the federal government and provinces that wish to maintain the flexibility inherent in the existing TCAs could result in a breakdown in the existing tax collection arrangements. This would create a significant compliance risk for taxpayers in terms of maintaining harmonious tax administration between the two orders of government.

REVITALIZING FEDERAL-PROVINCIAL/TERRITORIAL FISCAL RELATIONS

Funding for Aboriginal People

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FUNDING FOR ABORIGINAL PEOPLE

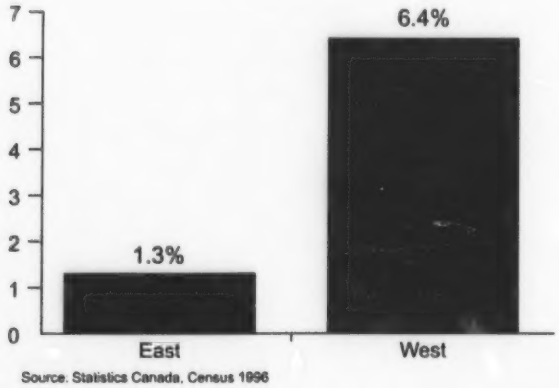
Introduction

Western provinces and territories recognize the importance of Aboriginal people in maintaining a diverse and economically strong region. At approximately 6.5% of the total Western population, Aboriginal people represent a significant segment of Western Canadian society.

Aboriginal peoples are facing considerable social and economic challenges. The Royal Commission on Aboriginal Peoples identified significant health and social issues in Aboriginal communities. It also identified that Aboriginal communities are disproportionately challenged by difficult economic conditions.

These obstacles necessitate a greater federal commitment to programs for Aboriginal people, such as increased funding for health care and skills training. Access to education for the growing Aboriginal population will need to be improved if Aboriginal peoples are to both contribute to and benefit from a strong Western economy.

Aboriginal Population as a per cent of Total Population



Source: Statistics Canada, Census 1996

The federal government has not met this challenge. Instead, provinces and territories have had to correspondingly increase their financial commitment to ensure that all provincial/territorial residents receive adequate public services

In addition, self-government, treaty, and land claims agreements generate new and expanding expectations for services, programs, and resources from both federal and provincial/territorial sources. In the absence of adequate federal funding, provinces and territories are left with the costs and the implications of fulfilling federal commitments.

National Forum on Health
Royal Commission on Aboriginal Peoples

- Unemployment rates, incidence of low educational attainment and welfare dependency are higher in First Nations communities.
- The incidence of violence, physical and sexual abuse and suicide is higher in Aboriginal communities.
- Aboriginal people are increasingly affected by conditions such as cancer and heart disease.
- Children in Aboriginal communities have higher rates of accidental death and injury.
- Many Aboriginal communities have higher rates of infectious diseases, such as tuberculosis and AIDS than non-Aboriginal Canadians.

Federal Throne Speech Commitments

- To work with Aboriginal people to help strengthen their entrepreneurial and business expertise;
- To support First Nations communities in strengthening governance, including implementing more effective and transparent administrative practices;
- To work to ensure that basic needs are met for jobs, health, education, housing and infrastructure;
- To work with First Nations to improve and expand the early childhood development programs and services available in their communities;
- To expand significantly the Aboriginal Head Start program;
- To co-operate with Aboriginal communities and provinces and territories on the measures required to reduce the number of aboriginal newborns affected by fetal alcohol syndrome;
- To reduce the incidence of preventable diabetes and tuberculosis especially among Aboriginal people; and,
- To take the measures needed to significantly reduce the percentage of Aboriginal people entering the criminal justice system.

Source: Speech from the Throne to Open the First Session of the 37th Parliament of Canada. january 30, 2001.

Conclusion

Western Finance Ministers emphasize the importance of assisting Aboriginal people in improving social and economic conditions as this will have a significant impact on the future well-being of Western Canada.

The requirement for adequate services for Aboriginal people is expected to continue to escalate. Without a strong financial commitment on the part of the federal government, this anticipated rise in services will result in greater hardship for Aboriginal people and increasing financial pressures on provinces/territories.

Western Finance Ministers continue to call for the federal government to accept its fiscal, historical, fiduciary, and constitutional responsibilities for Aboriginal people both on and off-reserve, and to consult with provinces and territories to address the needs of Aboriginal people.

Western Finance Ministers also call on the federal government to be accountable for both the current and on-going implications of emerging self-government and treaty issues, jurisdictional overlap, and fiscal relations.

2001 Western Premiers' Conference

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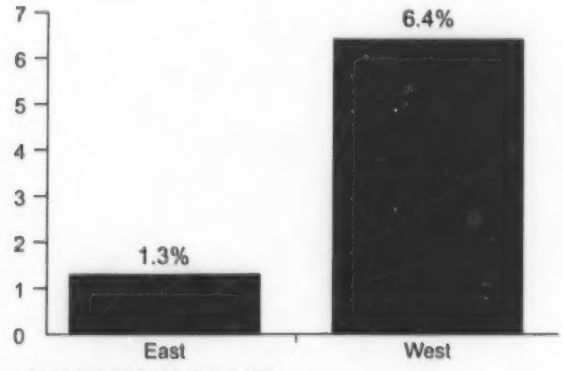

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- To support First Nations communities in strengthening governance, including implementing more effective and transparent administrative practices;
- To work to ensure that basic needs are met for jobs, health, education, housing and infrastructure;
- To work with First Nations to improve and expand the early childhood development programs and services available in their communities;
- To expand significantly the Aboriginal Head Start program;
- To co-operate with Aboriginal communities and provinces and territories on the measures required to reduce the number of aboriginal newborns affected by fetal alcohol syndrome;
- To reduce the incidence of preventable diabetes and tuberculosis especially among Aboriginal people; and,
- To take the measures needed to significantly reduce the percentage of Aboriginal people entering the criminal justice system.

Source: Speech from the Throne to Open the First Session of the 37th Parliament of Canada. January 30, 2001.

Conclusion

Western Finance Ministers emphasize the importance of assisting Aboriginal people in improving social and economic conditions as this will have a significant impact on the future well-being of Western Canada.

The requirement for adequate services for Aboriginal people is expected to continue to escalate. Without a strong financial commitment on the part of the federal government, this anticipated rise in services will result in greater hardship for Aboriginal people and increasing financial pressures on provinces/territories.

Western Finance Ministers continue to call for the federal government to accept its fiscal, historical, fiduciary, and constitutional responsibilities for Aboriginal people both on and off-reserve, and to consult with provinces and territories to address the needs of Aboriginal people.

Western Finance Ministers also call on the federal government to be accountable for both the current and on-going implications of emerging self-government and treaty issues, jurisdictional overlap, and fiscal relations.